Recent Developments

Corporate Liquidations Under I.R.C. Section 336 and the Tax Benefit Rule: *Tennessee-Carolina Transportation, Inc. v. Commissioner*

In *Tennessee-Carolina Transportations, Inc. v. Commissioner*,[1] the Sixth Circuit applied the tax benefit rule[2] to a corporate liquidation to which Internal Revenue Code section 336 was applicable.[3] This decision rejected the holding of the Ninth Circuit on the same question. In *Commissioner v. South Lake Farms, Inc.*,[4] the Ninth Circuit had held that the tax benefit rule did not apply to a corporate liquidation because no sale of corporate assets occurred.[5]

I. The Facts

The appellant Tennessee-Carolina Transportation, Inc. (Tennessee-Carolina), pursuant to a contract, purchased all the capital stock of Service Lines, Inc., which was similarly engaged in the motor freight transportation business.[6] Service Lines was operated as a wholly owned subsidiary of Tennessee-Carolina for two months.[7] It then distributed its assets to Tennessee-Carolina in liquidation.[8] Included among these distributed assets were truck tires and tubes that Service Lines had purchased for its own use.[9] Since the expected useful life of these tires and tubes was approximately one year, their cost was properly deducted by Service Lines when purchased.[10] The crux of the matter was that, pursuant to I.R.C. section 334(b)(2), Tennessee-Carolina could "claim a stepped-up basis in the assets received from Service by allocating the purchase price of the stock proportionately to the assets received based on their respective fair

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1. 582 F.2d 378 (6th Cir. 1978).

2. *Id.* at 379 n.1. The tax benefit rule provides that if an amount which was deducted from gross income in a prior year is recovered in a later year then the amount recovered is included in gross income in the later year. Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (Ct. Cl. 1967). *See generally* 1 J. Mertens, Law of Federal Income Taxation § 7.34 (1974). The rule is of judicial origin and has been codified in part in Internal Revenue Code § 111.

3. *Id.* at 379.

4. 324 F.2d 837 (9th Cir. 1963).

5. *Id.* at 839.

6. 582 F.2d at 379.

7. *Id.* at 379-80.

8. *Id.* at 380. The liquidation consisted of Service Lines distributing all of its assets to taxpayer in exchange for all its stock, which was then retired. This is an I.R.C. § 336 liquidation. I.R.C. § 337 employs a two-step procedure in which the acquiring taxpayer, here Tennessee-Carolina, would have purchased all of Service's assets (presumably at the same price it paid for Service's stock). Service Lines would then have liquidated and distributed the proceeds of the sale to its shareholders.

9. 582 F.2d at 380.

10. *Id.*

market value".[11] Thus, assets that would have had a zero basis to Service Lines were converted into assets with a basis equal to their fair market value in the hands of the transferee Tennessee-Carolina.[12] Upon allocation of $94,940.00 to these tires and tubes, Tennessee-Carolina deducted the entire amount as a business expense in its consolidated income tax return for 1967.[13]

The Commissioner asserted that the tax benefit rule required Service Lines to include in its income "an amount equal to the value of the previously expensed but not fully consumed tires and tubes which were distributed" to Tennessee-Carolina.[14] The full Tax Court upheld this position,[15] finding it necessary to reject the Ninth Circuit's holding in *South Lake Farms, Inc.*,[16] as "unduly restrictive."[17]

II. CORPORATE LIQUIDATIONS AND THE TAX BENEFIT RULE

Under section 336,[18] no loss or gain is recognized by a corporation on the distribution of property in partial or complete liquidation. Section 336 differs, however, from most nonrecognition provisions that provide a carryover basis for transferred property because it "ordinarily results in a permanent nonrecognition of the liquidating corporation's gain or loss."[19] Permanent nonrecognition results from the stepped-up basis that may occur under section 334(b)(2),[20] in which the taxpayer determines the basis for his assets by allocating the cost of the stock to the assets in proportion to the relative fair market value of the assets. Because of this tax-avoiding aspect of section 336, the Internal Revenue Service (IRS) has attempted to override section 336 by application of other theories such as the tax benefit rule.[21] For example, in *Tennessee-Carolina*, unless the liquidating

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11. *Id.*

12. Morrison, *Assignment of Income and Tax Benefit Principles in Corporate Liquidations*, 54 TAXES 902 (1976).

13. Tennessee-Carolina Transportation, Inc. v. Commissioner, 65 T.C. 440, 445 (1975). This value attributed to the tires and tubes was challenged. The Tax Court valued them at $36,394.67 which the Sixth Circuit affirmed. 582 F.2d at 379 n.2.

14. 582 F.2d at 380.

15. *Id.* This was a narrowly-decided case in which the Tax Court split eight-seven.

16. 324 F.2d 837 (9th Cir. 1963).

17. 582 F.2d at 380.

18. I.R.C. § 336 provides: "Except as provided in section 453(d) (relating to disposition of installment obligations), no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation."

In addition to the exception for installment obligations, narrow recapture rules, such as §§ 47(a)(1), 1245, and 1250 override § 336.

19. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶11.61, at 11-47 (3d ed. 1971).

20. For § 334(b)(2) to apply, several conditions must be satisfied. Generally, at least 80% of the stock must be acquired by "purchase," as defined in § 334(b)(3), during a period of not more than twelve months, and distribution must be pursuant to a plan of complete liquidation adopted not more than two years after the purchase. B. BITTKER & J. EUSTICE, *supra* note 19, ¶ 11.41, at 11-36 to -37.

21. *Id.*, ¶ 11.62, at 11-48.

corporation was required to recapture its prior tax deduction under tax benefit principles, there would be a double deduction for the same expense.

The IRS has also employed other theories in attempts to sidestep the nonrecognition provision of section 336. Since the Internal Revenue Code provides for taxation of income at both the corporate level when it is earned and the shareholder level when it is distributed, corporations may attempt to avoid taxation at the corporate level through an anticipatory assignment of income before it is reportable. To prevent a double exclusion of an income item, assignment of income principles are often employed.[22] These principles are the other side of the coin to the tax benefit rule, which prevents a double deduction of the same expense. Although *Tennessee-Carolina* did not consider the overlap of assignment of income and tax benefit principles,[23] the decision may possibly have an impact on the use of assignment of income arguments in other corporate liquidation cases.[24] Other theories include "clear reflection of income" under section 446(b).[25] This concerns the Commissioner's right to compel the use of another accounting method to reflect more accurately income. Another statutory argument invoked against liquidating taxpayers is section 482.[26] This section permits the IRS to allocate income and deductions between commonly-controlled organizations when it is necessary to prevent evasion of taxes or to reflect income clearly.

In *Commissioner v. South Lake Farms, Inc.*,[27] the Ninth Circuit rejected the application of the tax benefit rule to a corporate liquidation in the absence of a sale of the corporate assets. There the liquidating corporation had deducted expenses for the planting and cultivation of a cotton crop and the preparation of land for raising barley.[28] The corporation was liquidated, however, in accordance with section 336 prior to the harvesting of either crop.[29] Under section 334(b)(2), the acquiring corporation obtained a basis for these unharvested crops that included the

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22. Morrison, *supra* note 12, at 905. However, the application of assignment of income principles to § 336 liquidating distributions is haphazard due to the importance of the timing of distributions and the termination of corporate existence. *Id.* at 905-15, 923.

23. *Id.* at 922. This occurs "whenever currently deductible expenses and expectations of future profits are combined in a single zero-basis asset." *Id.*

24. *Id.* Morrison suggests three areas of impact. First, tax benefit principles may be used as an alternative argument to an assignment of income theory which is often defeated either by termination of the corporate existence or the limitation of such assignment principles to "fully earned" income. United Mercantile Agencies, 34 T.C. 808 (1960). Second, the legal fiction of "receipt of an asset" employed in *Tennessee-Carolina* may be extended to assignment of income cases. Third, § 334(b)(2) liquidations may be treated different from other § 336 liquidating distributions.

25. B. BOTTKER & J. EUSTICE, *supra* note 19, ¶ 11.62, at 11-49. In *South Lake Farms, Inc.*, the § 446(b) argument was rejected by both the Tax Court and the Ninth Circuit.

26. B. BITTKER & J. EUSTICE, *supra* note 19, ¶ 11.62, at 11-50. Bittker also mentions the possibility of taxation at the corporate level of contingent or "inchoate" income items when the corporate existence was not properly terminated. This emphasizes the importance of a "timely" liquidation to defeat the application of assignment of income principles. *Id.*, ¶ 11.62, at 11-50 to -57.

27. 324 F.2d 837 (9th Cir. 1963).

28. *Id.* at 838.

29. *Id.*

value created by the deducted expenses.[30] The Ninth Circuit held that since the requisite recovery of the earlier deduction by the liquidating corporation had not occurred, the tax benefit rule would not apply.[31]

Following *South Lake Farms, Inc.*, Revenue Ruling 74-396[32] was issued. It required a subsidiary corporation liquidated into its parent corporation in a non-taxable transaction under sections 332, 334(b)(2), and 336 to include in its gross income, under the tax benefit rule, the allocated value of incidental supplies it distributed to its parent for which a deduction had been taken in the previous year resulting in a full tax benefit.[33] It also concluded that the *South Lake Farms, Inc.* interpretation of recovery was erroneous.[34] An apparent conflict developed, however, when the IRS published its acquiescence in the Tax Court's consideration of *South Lake Farms, Inc.*[35] This conflict was explained in Revenue Ruling 77-67,[36] which withdrew the acquiescence. The explanation for the acquiescence was that the Tax Court considered only sections 446(b) and 482.[37] Since the issue of the applicability of the tax benefit rule had not been raised until the case was before the Ninth Circuit, the IRS' acquiescence did not comment on the tax benefit rule.

III. ANALYSIS

In *Tennessee-Carolina,* the Sixth Circuit approached from several directions taxpayer's argument that the tax benefit rule required a recovery of the amount previously deducted.[38] First, the court found that the denial of the applicability of the tax benefit rule "would produce an unnecessary disparity between liquidations governed by § 336 and those governed by Internal Revenue Code § 337."[39] In this case, a section 337 liquidation could have been accomplished in two steps: first, the taxpayer would have purchased all of the liquidating corporation's assets at the same price it would have paid for the stock, and second, the liquidating corporation would have distributed the proceeds of the sale to its shareholders in liquidation. The business consequences of either method would have been

30. *Id.*

31. *Id.* at 840. The lack of the element of recovery was based upon the theory that the liquidating corporation received nothing: "It was the stock of the old corporation that was sold, and the stockholders who got the money." *Id.* at 839. Therefore, the gains were attributable to the stockholders. *Id.* This results, however, in the benficial substitution of greater capital gains for the shareholders for the taxation of the gain at ordinary corporate tax levels before distribution to the shareholders. *See* Epstein, *The Tax Benefit Rule in Corporate Liquidations,* 6 TAX ADVISOR 454 (1975).

32. 1974-2 C.B. 106.

33. *Id.* at 106.

34. *Id.* at 107.

35. *See* 1975-1 C.B. 2.

36. 1977-1 C.B. 33.

37. *Id.* at 34.

38. "It [taxpayer] contends that Service [Lines, Inc.] had no 'recovery' of its expense deduction for the tires and tubes since it distributed them directly to taxpayer and received nothing in exchange." 582 F.2d at 380.

39. *Id.*

identical.[40] Under section 337, however, the tax benefit rule would apply in accordance with *Anders v. United States.*[41]

Having stated that the tax benefit rule applies to section 337 liquidations, the court applied the general rule that sections 336 and 337 liquidations should be treated alike unless some peculiar provision of section 337 justifies disparate treatment.[42] This parity theory had also been discussed by the Sixth Circuit in a case in which it applied the assignment of income doctrine to override the general nonrecognition provisions of section 337.[43] This parity argument is a concern over the "fundamental inequity" that would result if similar sections 336 and 337 cases were treated differently.[44] The majority concluded its opinion with a refusal "to elevate form over substance by reviving technical differentiations put to rest in 1954 with the adoption of § 337."[45]

Even if the parity argument was insufficient, an alternative theory was provided by the court. The failure of the tax benefit rule in *South Lake Farms, Inc.* was predicated on the absence of any recovery of the previously deducted amount. The Sixth Circuit rejected the requirement of an actual physical "recovery" of some tangible asset;[46] instead, it held that [t]he rule should apply whenever there is an actual recovery of a previously deducted amount *or* when there is some other event inconsistent with that prior deduction."[47] The latter standard, which was applicable in *Tennessee-Carolina,* serves "to counteract the inflexibility of the annual accounting concept. . . ."[48]

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40. "Service liquidated, Service's shareholders in possession of the proceeds of the sale in exchange for retirement of their stock, and the taxpayer in possession of Service's assets with a basis equal to their purchase price." *Id.* at 381.

41. 462 F.2d 1147 (Ct. Cl.), *cert. denied,* 409 U.S. 1064 (1972). This is one of a series of decisions beginning with Commissioner v. Anders, 414 F.2d 1283 (10th Cir.), *cert. denied,* 356 U.S. 958 (1969), in which "it has become fairly established that section 337 must yield to the tax benefit rule." O'Hare, *Application of the Tax Benefit Rule in New Case Threatens Certain Liquidations,* 44 J. TAX. 200 (1976). The majority in the Sixth Circuit noted this article in a footnote. 582 F.2d at 380 n.7.

42. 582 F.2d at 381. The dissent argued that § 337 was "enacted as a shield to protect the taxpayer, and not as a sword to be utilized by the Government." *Id.* at 388. For a short history of § 337 and the reasons for its enactment, *see* B. BITTKER & J. EUSTICE, *supra* note 19, ¶ 11.63-64. For an argument against the finding of parity between §§ 336 and 337, see Epstein, *supra* note 31, at 456.

43. Midland-Ross Corp. v. United States, 485 F.2d 110, 117 (6th Cir. 1973). The Tax Court has adopted a similar parity rationale. *See* John T. Stewart, III, Trust, 63 T.C. 682 (1975).

44. 582 F.2d at 383.

45. *Id.* The accompanying footnote indicates the majority's belief that the court need not wait for Congressional action. *Id.* at 383 n.16. This is consistent with the majority's earlier statement that the court "should not hesitate to avoid inequities in the tax laws which are not specifically mandated by Congress." *Id.* at 381 n.11. The dissent argued that "[i]f there is to be parity in tax treatment under the two sections, the tax results dictated by Section 336 should control Section 337, and not vice versa." *Id.* at 388 (Weick, J., dissenting). *See* Morrison, *supra* note 12, at 919.

46. *Id.* at 382.

47. *Id.* (emphasis in original). The court cites in support of this proposition: Block v. Commissioner, 39 B.T.A. 338, 340-41 (1939), *aff'd. sub nom.* Union Trust Co. v. Commissioner, 111 F.2d 60 (7th Cir.), *cert. denied.,* 311 U.S. 658 (1940). The dissent argues that the supporting language in *Block* was nothing more than dictum. *Id.* at 384 (Weick, J., dissenting).

48. *Id.* at 382. The annual accounting concept is often employed by the Service to compel the taxpayer to use a method that clearly reflects income. Section 446(b), however, has not been that useful a device, as indicated by the rejection of the Commissioner's argument based upon § 446(b) in *South Lake Farms, Inc.,* 324 F.2d at 838.

The court also found that there had been a recovery since, at the time of the liquidation, a usable asset was transferred to the taxpayer.[49] "Thus, in order for Service to be able to transfer them [tires and tubes] to taxpayer, they must be deemed to have been recovered by Service at that time. . . ."[50] This recovery had been objected to as a legal fiction.[51] The Sixth Circuit countered this charge, stating that it was no more fictional than the initial fiction which converted the tires and tubes into a nonentity. Thus, the majority held that equity required this fictional reconversion into tangible property.[52] A further response to the contention that an actual recovery is required was that the receipt of its own stock in exchange for the assets transferred to taxpayer constituted an actual recovery.[53]

The requirement of an actual economic recovery before the tax benefit rule can be applied was discussed in *United States v. Nash.*[54] In *Nash,* the taxpayers had transferred to newly formed corporations accounts receivable for which a bad debt reserve had been established. No recovery of the amount of the bad debt reserve was found by the Supreme Court. The rationale was that the taxpayer had only transferred the *net value* of the receivables (face amount less bad debt reserve) to the new corporations and had received stock worth that net value in exchange.[55] The majority stated that *Nash* was distinguishable from the situation in *Tennessee-Carolina* since Service Lines had clearly transferred items that had been the subject of prior deductions rather than only what was left after the deduction.[56] The dissent conceded that *Nash* implied that the tax benefit rule would apply when the value of the securities received for the accounts receivable exceeded the receivables' net worth. The dissent, however, argued that the shareholders and not Service Lines recovered the tax benefit.[57] To this, the majority responded that *Nash* sought to reflect business reality rather than reject the "fictional" recovery theory.[58] Only a further clarification of *Nash* can resolve this dispute.[59]

It can be argued that since Congress can develop statutory recapture devices, the courts should refuse to police the area of corporate

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49. 582 F.2d at 382.

50. *Id.*

51. *Id. See also* Morrison, *supra* note 12, at 917.

52. 582 F.2d at 382.

53. *Id.* "It is true that this stock had no value *after* the liquidation was completed, but it had considerable value *at the time it was returned* to Service. This is enough to satisfy any need for a 'recovery' by Service in order to apply the tax benefit rule." *Id.* (emphasis in original). The dissent responded that "to attribute an economic recovery to the liquidating corporation from the transfer of its assets for its stock would circumvent the explicit nonrecognition language of 26 U.S.C. § 336." *Id.* at 385 n.4 (Weick, J., dissenting).

54. 398 U.S. 1 (1970).

55. *Id.* at 4.

56. 582 F.2d at 383.

57. *Id.* at 384-85 (Weick, J., dissenting).

58. *Id.* at 383.

59. *See* Rev. Rul. 78-278, 1978-30 I.R.B. 5.

liquidations for Congress.[60] This view, however, is too narrow an interpretation of the courts' statutory construction powers. To maintain that if there is to be parity under sections 336 and 337 the tax result dictated by section 336 should control[61] would be contrary to the decisions in several jurisdictions in which the relationship between section 337 and the tax benefit rule has been considered.[62] Since Congress has not mandated inequitable results between sections 336 and 337, the Sixth Circuit properly avoided such a construction. The court's decision also avoided the creation of another tax trap for the unwary similar to that existing prior to the enactment of section 337.[63]

In an article[64] following the Tax Court's decision, several inconsistencies were noted that were not addressed on appeal to the Sixth Circuit. One deals with the treatment afforded appreciated inventory received in a liquidation under section 334(b)(2), in which the stepped-up basis in the hands of the parent means that the appreciation is not recognized as income by the parent on the sale of the inventory.[65]

> It is unclear why the distribution of property with a value in excess of basis due to the earlier deduction of the basis should result in income while the appreciation on inventory distributed under Section 334(b)(2) goes unrecognized as income even though it is sold in the ordinary course of business by the parent corporation after liquidation.[66]

Another problem concerns the adjustments in the parent's basis in the stock following the recognition of income by the subsidiary under the tax benefit rule.[67] Treasury Regulations sections 1.334-1(c)(4)(V)(a)(1) and (2) require an increase in the adjusted basis of the subsidiary's stock held by the parent with respect to which the distributions in liquidation are made (1) by the amount of any unsecured liabilities assumed by the parent, and (2) by the portion of the subsidiary's earnings and profits that arise between the date of the acquisitions of the stock and the liquidating distribution.[68] Thus, the parent gets a double step-up in basis as the net increase in earnings and profits and the amount of income tax liability assumed by the parent increase the adjusted basis of the stock. If all this increase in

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60. *See* B. BITTKER & J. EUSTICE, *supra* note 19, ¶ 11.62, at 11-52.

61. *See* text accompanying note 43 *supra*.

62. Anders v. United States, 462 F.2d 1147 (Ct. Cl.), *cert. denied*, 409 U.S. 1064 (1972); Spitalny v. United States, 430 F.2d 195 (9th Cir. 1970); Commissioner v. Anders, 414 F.2d 1283 (10th Cir.), *cert. denied*, 356 U.S. 958 (1969).

63. 582 F.2d at 383 n.16. Section 337 was enacted to eliminate the tax trap created by Commissioner v. Court Holding Co., 324 U.S. 331 (1945), and United States v. Cumberland Pub. Serv. Co., 338 U.S. 451 (1950), in which a selling-before-distributing liquidation was subject to double taxation while a distributing-before-selling liquidation was only taxed once.

64. O'Hare, *supra* note 41, at 200.

65. *Id.* at 201-02. *See* Knapp King-Size Corp., 527 F.2d 1392 (Ct. Cl. 1975).

66. O'Hare, *supra* note 41, at 202.

67. *See* Morrison, *supra* note 12, at 919-22; O'Hare, *supra* note 41, at 202-03.

68. *See* O'Hare, *supra* note 41, at 202.

adjusted basis were allocated to the tires and tubes or to other items that could be expensed, the effect of the tax benefit rule would be meaningless.[69] Allocation methods other than specific allocation to the asset causing the adjustments, however, are available. On the other extreme would be the allocation of the additional basis solely to goodwill in which case the offsetting deduction would be completely eliminated.[70] Another method would be the allocation of an increased basis among all the assets, thereby minimizing the offsetting deduction.[71]

The decision in *Tennessee-Carolina* is significant in several respects. First, it creates a conflict between the Sixth and Ninth Circuits concerning the applicability of the tax benefit rule in section 336 corporate liquidations.[72] Second, it is a judicial attempt to establish parity as a general rule between sections 336 and 337. Third, its result necessitates a clarification of *Nash*'s recovery standard. Finally, it raises a question of basis adjustment and its appropriate allocation among the distributed assets. Because of these uncertainties, one commentator has suggested that tax planners should consider adopting a liquidation plan that would fall beyond the ambit of section 334(b)(2) or postponing the liquidating distribution until the expensed property is entirely consumed.[73] Another suggested alternative would be a direct purchase of the assets in which only the selling corporation would be affected by the tax benefit rule.[74]

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69. *See id.*; Morrison, *supra* note 12, at 920. Both authors argue that this interpretation is supported by a reasonable literal reading of the Regulations and First National State Bank of New Jersey, 51 T.C. 419 (1968).

70. O'Hare, *supra* note 41, at 203.

71. *Id.*

72. O'Hare also discusses the applicability of *Tennessee-Carolina* to §§ 331 and 333. *Id.*

73. O'Hare, *supra* note 41, at 204.

74. *Id.*